TOPIC 13: CORPORATE GOVERNANCE

Overview

Corporate governance concerns the procedures and mechanisms associated with administering a business entity. Principles of corporate governance include legal and ethical principles controlling the governance procedures and the conduct of those administering the business. This chapter focus on the corporate entity form. It will examine the internal stakeholders and their roles in the business entity. It will examine the theories of governance applicable to the corporate entity form, the duties and procedural requirements of those administering the business, and the methods by which stakeholders may enforce those duties. Lastly, the chapter will explore numerous laws, organizational requirements, and ethical standards that affect corporate governance practice.

VIDEO LESSON - INTRODUCTION

VOCABULARY & CONCEPTS

- Business Governance
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- Closely-held Corporation
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    - White Knight & Pac Man
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TOPIC 13: CORPORATE GOVERNANCE - QUESTIONS & ANSWERS

1. What is "business governance"?

Business governance concerns the actions and controls placed on those charged with managing a business entity. Business governance is the subject of extensive legislation and research, particularly as it pertains to the corporate entity form. Corporate governance generally concerns the internal control of a corporation as influenced or controlled by state and federal law, rules of ethics, and industry standards. It specifically focuses on the actions of managers and directors and the observance of procedural safeguards of shareholder rights.

- *Example*: Issues in corporate governance include, voting rights, meeting requirements, approval of corporate actions, record retentions, disclosure of information, and any other procedural undertakings concerning the management of the corporation.

- ***Discussion***: Why do you think corporate governance is the subject of academic research rather than simply the mechanical functions of corporate governors? How does corporate governance relate to the personal attributors of entity governors?
- ***Resource Video***: http://thebusinessprofessor.com/what-is-business-governance/

2. Who are the members of a corporation?

The corporation is made up of shareholders, directors, officers, and employees. Shareholders are the owners of the corporation. Directors undertake the high-level management and decision-making for the corporation. Officers (and their subordinate employees) run the daily operations of the corporation. Each member of the corporation has specific rights and duties attached to her position. These rights and duties can become confusing when a single individual holds more than one position (such as shareholder, directors, and officer) of the corporation.

- *Note*: Besides shareholders, directors, and officers, there are numerous other corporate stakeholders (such as vendors, customers, other businesses, etc.) that are not members of the corporation.

- ***Discussion***: Why do you think corporations are organized in the fashion with designated authority and rights? Do you feel that corporate governance should take into consideration stakeholders other than shareholders, directors, or officers? Why or why not?
- ***Resource Video***: http://thebusinessprofessor.com/members-of-a-corporation/

3. What is a "closely-held corporation"?

A closely-held corporation is owned and controlled by a small group of owners or shareholders. These shareholders hold the shares of stock necessary to elect most or all of the directors. Often, shareholders in a closely-held corporation will elect themselves to serve as directors and appoint themselves as officers. Family-owned businesses commonly organize as closely-held corporations. In these entities, members of a single family own most or all of the outstanding shares. They also serve as directors and officers of the business. Shareholders generally have limited fiduciary duties to the corporation. With a single or small group of shareholders holding a majority of the voting shares in the corporation, minority shareholders rarely have much influence in the corporation. In such instances, common law generally holds that majority shareholders have fiduciary duties to exercise care and loyalty with regard to the corporation. This is particularly true in closely-held entities. Given the difficulty of enforcing one's rights, these standards offer little protection to the minority shareholder.

- *Note*: In some situations, minority shareholders may be able to bring a direct action against the corporation if their individual rights are harmed. Further, they may be able to bring a derivative action on behalf of the corporation against majority shareholders who fail to exercise care and loyalty in carrying out their corporate duties. In such actions, the court may assess damages against the majority shareholders or issue injunctions to halt the harmful conduct.

- ***Discussion***: Do you believe that closely-held corporations should be governed or subject to the same governance requirements as widely-held or public corporations? Why or why not? Does the close connection between shareholders and the business entity affect your opinion? Why or why not?

- ***Practice Question***: Can you identify the most profitable or heavily-capitalized, closely-held corporations in the United States?

- ***Resource Video***: http://thebusinessprofessor.com/closely-held-corporations/

4. What is the distinction between a "private company" and "public company"?

A private company is a business whose ownership interest is not openly held or traded by the public at large. Company ownership is not sold in the public market. As such, all ownership interests are acquired *via* personal transactions with the company or other owners of the company. A public company, on the other hand, is a business whose ownership is openly traded in the market. Often, the ownership interest will be traded on a public "stock exchange". If the shares are not listed on an exchange, the shares are generally available for purchase through securities brokers in what is known as "over-the-counter" transactions. Public companies are subject to far more extensive regulation than private companies. This reality often leads public companies to repurchase outstanding shares from the public market in a transaction known as "going private".

- *Note*: Most public companies are corporations. There are, however, limited instances where shares of ownership in other types of entities are sold publicly. An example would be master limited partnership interests.

- ***Discussion***: Why do you think that public and private companies are subject to different levels of regulation?

- ***Practice Question***: Stock of ABC Corp is traded on a public exchange. Milly makes a tender offer to shareholders and acquires all of the outstanding shares of ABC. At this point, is ABC Corp a public or privately held company?

- ***Resource Video***: http://thebusinessprofessor.com/distinction-between-private-and-public-company/

THEORETICAL FOUNDATIONS

5. What is the role and purpose of the corporation?

The concept of the corporation originated through governmental charter allowing individuals to carry on business collectively. Basically, the charter gave the corporate entity form legal status that was similar to personhood. The concept of the corporation as a legal person has expanded over time to the point that corporations enjoy many of the same constitutional protections as US citizens. The corporate entity also allows individuals to have a beneficial interest without being actively involved in business operations. That is, it allows for increased division and transfer of ownership interest in a business activity. It allows for the utilization of outside capital from investors (rather than just debt or capital contributions from founders) to grow business operations. The active trading of ownership in corporate entities gave rise to the formation of US stock exchanges and the private equities market.

- ***Discussion***: How do you feel about the corporate entity form? Should the corporation be treated as a separate person with rights similar to those of citizens? Why or why not? How do you think the availability of capital funding relates to corporate growth and the creation of new business entities?
- ***Practice Question***: How does a corporation facilitate business practice and benefit society?
- ***Resource Video***: http://thebusinessprofessor.com/role-and-purpose-of-corporate-entity-form/

6. What is "agency theory" and why is it relevant for the business entity?

Agency theory posits that corporations act as agents of its shareholders. That is, shareholders invest in corporate ownership and thereby entrust their resources to the management of the directors and officers of the corporation. In larger corporations, there is often a sharp divergence between the short and long-term interest of officers and shareholders. This is primarily brought on by short-term demand for profits and the asymmetry of information that officers and directors possess compared with that of shareholders. The divergence of interest between officer, director, and shareholder is thought to influence the actions and decisions of officers and directors who may become detached from shareholder interests. Corporate governance rules seek to establish a legal framework similar to that of the agent-principal relationship. These rules seek to align the incentives of officers and directors with those of shareholders. They seek to establish norms and customs that prevent the adverse results of divergent corporate interests. Further, agency theory lends itself to the duties that officers or director owe to the corporation.

- ***Discussion***: How do you feel about the principal-agent view of the corporate form? What are the advantages and disadvantages of this view? Do you believe that corporate governance procedures are effective in aligning officer, director, and shareholder incentives? Why or why not?
- ***Resource Video***: http://thebusinessprofessor.com/agency-theory-and-stakeholder-theory/

7. What is the "stakeholder theory" of corporate governance?

The stakeholder theory of corporate governance focuses on the effect of corporate activity on all identifiable stakeholders of the corporation. This theory posits that corporate managers (officers and directors) should take into consideration the interests of each stakeholder in its governance process. This includes taking efforts to reduce or mitigate the conflicts between stakeholder interests. It looks further than the traditional members of the corporation (officers, directors, and shareholders) and also focuses on the interests of any third party that has some level of dependence upon the corporation. Stakeholders are generally divided into internal and external stakeholders.

- *Internal Stakeholders* - Are the corporate directors and employees, who are actually involved in corporate governance process.

- *External Stakeholders* - May include creditors, auditors, customers, suppliers, government agencies, and the community at large.

These stakeholders exert influence but are not directly involved in the process. Key to the stakeholder theory is the realization that all stakeholders engage in some manner with the corporation with the hope or expectation that the corporation will deliver the type of value desired or expected. The benefits may include dividends, salary, bonuses, additional orders, new jobs, tax revenue, etc.

- ***Discussion***: How do you feel about the stakeholder theory of corporate governance? Should external stakeholders have rights or even be considered in the governance process? Why or why not? To what extent does the current state of corporate governance law focus on the external stakeholder? How, if at all, do you see this trend changing in corporate governance laws and practice?

- ***Resource Video***: http://thebusinessprofessor.com/stakeholder-theory-of-corporate-governance/

SHAREHOLDERS OF THE CORPORATION

8. What is the role of "shareholders" of the corporation?

Shareholders are the owners of the corporation. They have ownership rights in the shares of corporate stock. The role of the shareholder in the corporation is limited, however, as they have neither the right nor the obligation to manage the day-to-day business of the enterprise. Shareholder rights vary pursuant to the type of stock owned and the applicable state law. State law is heavily influenced by authoritative sources, such as the Model Business Corporations Act (Model Act). Below is an explanation of common rights afforded corporate shareholders under state law.

- *Right to Information* - Shareholders have the right to access and examine corporate records and information concerning the governance and financial performance of the entity. In public companies, much of the operational and financial information about a corporation must be reported to the public by filing with the Securities Exchange Commission. Companies must also disclose this information directly to shareholders on largely standardized reporting documents. Private companies, on the other hand, do not publicly report information. Further, there is no specific requirement to make periodic disclosures to shareholders. As such, shareholders in non-public entities must generally make requests for information. State law provides for the substantive and procedural rights of shareholders to access and review corporate records.

- *Example*: James is concerned that directors of ABC Corp are not exercising due care in the management of the company. She may seek access to company information to further understand management's actions. This may include minutes from director meetings. The company must generally afford her access to these records.

- *Right to Vote* - All corporations must have at least one class of stock representing an ownership interest in the company. In most corporations, the basic ownership share is known as "common stock". These shares entail voting rights for the shareholder.

  - *Election of Directors* - At the annual meeting, shareholders have the right to elect directors. A corporate nominating committee of the board of directors produces a slate of directors and recommends election of a single director per available board seat. The names of nominated directors are listed on a proxy statement and sent to shareholders. The shareholders may either vote for the nominated director or abstain from voting. Under "plurality voting", a director must receive a majority of votes cast to be elected to the board. This is a very low standard when there is only one nominated director on the proxy statement. This rule has been superseded in most large corporations in favor of a rule that requires a director receive at least a majority of outstanding votes.

    - *Note*: Shareholders may also nominate their own candidates to the board. This generally requires the shareholders to justify their nomination and prepare and distribute their own proxy material. This is process is known as a "proxy contest". Some state laws, as well as the NYSE and NASDAQ, both require that the members of the nominating committee be independent or not employees of the company.

    - *Example*: ABC Corp is having an election of directors. ABC appoints Tom and Jerry, who are friends of the current directors but are not board members, to the nominating committee. Tom and Jerry recommend Sarah for director. The board agrees and places Sarah's name on the proxy solicitation. I am a shareholder and receive the proxy with Sarah's name. The board follows plurality voting, so Sarah must receive a majority of all votes cast, rather than a majority of votes outstanding. I can vote for Sarah, abstain from voting, or wage my own proxy contest to recommend a director of my choosing. I disagree with Sarah as director but know that sending proxy solicitations to all shareholders would be burdensome and expensive. Further, I know that it is unlikely that I will receive more votes for my nominee that Sarah will receive, so Sarah will win anyway. I decided to abstain from voting.

  Boards generally employ either "straight voting" or "cumulative voting" to elect directors.

    - *Straight Voting* - This method allows a common shareholder one vote per share of common stock for each available seat on the board of directors.

      - *Example*: Gail owns 100 common shares of stock in ABC Corp. When two director seats come open, she may cast up to 100 votes to elect each director.

    - *Cumulative Voting* - This method allows a common shareholder a number of votes equal to her number of shares times the number of director seats available. She may cast these votes for any one or all of the available board seats.

- *Note*: Cumulative voting amplifies the voting power of a shareholder.

- *Example*: Tammy owns 100 common shares of stock in ABC Corp. When two director seats come open, she has 200 votes (100 shares x 2 director seats) to cast. She can cast all 200 votes for one director or split up her votes as she wishes.

- *Fundamental Changes in Corporation* - Shareholders must approve any fundamental changes to the corporation. Fundamental changes include:

  - *Mergers* - This is the situation in which two companies combine to form one. The shareholders of the company being consumed must always approve this decision. The bylaws will determine whether the shareholders of the consuming corporation must approve the transaction. If the companies will merge to form a new corporation, generally the shareholders of both corporations must approve the transaction.

    - *Note*: The corporate bylaws will lay out the number or percentage of shareholder votes required for approval. In the absence of specific rules in the bylaws, the default state-law rules will control.

  - *Sale of Assets* - Shareholders must approve the sale of all or substantially all" of the corporate assets. The idea is that this is effectively the equivalent of merger or shutting down the corporation.

  - *Dissolution* - Shareholders must approve the shutting down or "dissolution" of the corporation.

    - *Note*: Shareholder approval is not required when a state takes action to involuntarily dissolve a corporation.

- *Changes in Governing Documents* - Shareholders have the right to vote for any changes or amendments to the governing corporate documents. This includes rights to vote on:

  - *Amendments to the Charter* - Directors must initiate any changes to the articles of incorporation or charter. Once proposed, shareholders vote to approve or disapprove the directors' proposal.

  - *Amendments to the Bylaws* - The bylaws will direct the requirements and procedure for amendment. In the absence of provisions in the bylaws addressing this issue, state corporation law will supply the default rules.

All shareholders are entitled to vote on matters presented at shareholder meetings.

- *Meeting Rights* - All state corporate statutes (as well as large public exchanges) require corporations to hold annual shareholder meetings. During these meetings, the corporation will conduct any required or desired corporate governance actions, such as electing directors. The requirement to hold meetings may be relieved for small corporations that handle these matters through unanimous written consent by the shareholders. Directors and large blocks of shareholders may call special meetings for any number of purposes. Notably, special meetings are appropriate when shareholders must vote upon a fundamental change to the corporation. Various state laws protect shareholder meeting rights.

- *Note*: Under many state laws (specifically those conforming to the Model Act), large shareholders may have the right to call special meetings to vote on matters of immediate concern.

    - *Note*: Generally, shareholders holding 10% or more of a corporation's shares are considered large shareholder and may call a special meeting.

- *Example*: Some states require 70 days notice of any intended meeting and specific requirements that a quorum of shareholder be present or represented during any meeting.

- *Right to Make Proposals* - Certain shareholders have the right to propose specific corporate actions to be taken at corporate meetings. This is normally done through adding these agenda items to corporate proxy statements. Under state law, a shareholder holding 1% of the outstanding shares or $2,000 worth of shares may request a proposal be placed in the corporate proxy material for shareholder vote. The primary limitation is that the shareholder proposal cannot usurp management's authority by making proposals related to ordinary business operations. If the shareholder proposal relates to the authority or rights reserved for shareholders, the result of the vote on the shareholder proposal is binding on the corporation. Proposals that are outside the ordinary authority of shareholders (i.e., it is a decision reserved to directors or officers), the proposal is not binding upon the board or officers.

- *Note*: The board may reject a shareholder's proposal for material to be included in the proxy material. State law and the corporate governance documents will determine the ability of a shareholder to make proposals above director approval. The types of proposals that shareholders may wish to make commonly include resolutions regarding environmental practices, political spending, labor practices, etc.

- *Example*: I am a corporate shareholder of ABC Corp. I own 2% of the corporate stock. I want the corporation to vote on a resolution to mandate that corporate boards consist of 75% outsiders who have no relationship with current directors or officers. As a qualified shareholder, I can require that this proposal be included in the proxy material. The election of directors is a fundamental right of shareholders. It is possible that shareholder approval of such a resolution would be binding upon the board.

• *Right to Dissent* - In most states (and under the Model Act), corporate law allows for "dissenter rights". Dissenter rights are a special group of rights designed to provide protections to shareholders in corporations that are not actively traded in the market. In a widely-held, public company, shareholders who do not agree with fundamental issues of corporate management or governance can sell their ownership interest. This is generally not an option for shareholders in closely-held and private corporations. Dissenter rights allow these shareholders to force the corporation to buy back their shares at "fair value".

- *Note*: This right is not available for shareholders who disagree with non-fundamental aspects of corporate governance.

- *Example*: I am very upset that the corporation allows for plurality vote in the election of directors. The board is not very receptive to shareholder input regarding the nomination committee or the qualifications of directors. As such, I may exercise my dissenter's rights and require the corporation to purchase my shares of ownership.

- ***Discussion***: How do you feel about the fundamental rights of shareholders? Should the rights be more or less extensive? Why or why not? Can you think of an example of any other rights or authority that could serve to further protect shareholder rights?

- ***Practice Question***: Mark suspects that the directors of the corporation have engaged in actions that are detrimental to the corporation and shareholder interests. What rights does Mark have to investigate the director's actions? If Mark is correct, what shareholder rights provide Mark with the ability to prevent this type of activity in the future?

- ***Resource Video***: http://thebusinessprofessor.com/role-of-shareholders-of-the-corporation/

9. What are the many variations in characteristics of the "ownership structure" of the corporations?

At the time of formation, a corporation authorizes shares to issue to shareholders in exchange for capital.

- *Promoters and Stock Subscription Agreements* - Often the "promoters" of the corporation will seek promises from individuals to purchase stock in the corporation once it is fully formed. These "subscription agreements" provide certainty that the corporation will have operational capital post formation.

- *Authorized & Issued Shares* - The number of "authorized shares" of the corporation is stated in the articles of organization. This number generally far exceeds the number of shares actually issued to shareholders ("issued shares"). The corporation will retain the ability to issue more shares in the future.

- *Treasury Stock* - Sometimes the corporation will repurchase shares that have been issued. The repurchased shares are held by the corporation as "treasury stock". There are a number of strategic reasons for repurchasing issued shares.

- *Equity Compensation* - Corporations often award additional shares to current shareholders as a form of dividend. This has the effect of transferring the value of the stock dividend from the retained earnings to the corporation's shareholder's equity or capital account.

- *Stock Split* - If the corporation has a need for additional shares, it may authorize more shares or execute a "stock split". A stock split effectively doubles the number of outstanding shares and reduces the share value by one half. This will double the amount of treasury stock on hand and the lower stock value generally serves to make the stock more liquid.

- *Share Transfers* - Unless there is an agreement otherwise, shareholders may generally transfer their stock to others. This may require the corporation to collect the seller's shares and distribute new shares to the purchaser.

Stock can be divided into categories called "classes", and these classes can be further divided into subcategories called "series". Series simply indicate the time of issuance of a certain number of shares. Different classes of stock may have very different rights. For example, a class of preferred stock is different from a class of common stock. All series in a class are fundamentally the same, except for minor distinctions. Classes of stock ownership are generally categorized as follows:

- *Common Stock* - Common stock is the baseline corporate ownership interest. Common shareholders have general voting rights but hold the lowest priority for payment of dividends in the event of distribution or liquidation of the corporation.

- *Preferred Stock* - Corporations authorize and issue preferred stock for a specific purpose. Generally, this purpose is to provide special rights to certain shareholders, such as investors and corporate founders.

- *Stock Options & Warrants* - Options and warrants provide the right to purchase a given quantity of stock at a stated price. These are used to incentivize the holders to work to raise the value of corporation shares. Also, these instruments may provide tax incentives to the recipient. These rights can be very important when the value of the stock rises above the purchase price.

There can be an infinite number of classes of preferred shares — each with unique rights. The most commonly designated special rights associated with preferred shares are as follows:

- *Dividends* - Common shareholders may receive dividends as an entitlement of corporate ownership. Preferred shareholders often receive priority of payment of dividends above common shareholders. This type of right varies, but generally a preferred shareholder will receive full payment or distributions of dividends before common shareholders receive anything. For example, "cumulative dividend rights" means that the preferred shareholder will receive full payment of any current and past, unpaid dividends before common shareholders receive payment of current dividend distributions.

- *Liquidation* - Preferred shareholders generally receive a liquidation preference. This means that the preferred shareholder will be paid first from the proceeds of any sale or liquidation of the corporation or its assets. Often, preferred shareholders will receive some stated amount or multiple of their initial investment before other shareholders receive any distribution.

- *Voting Rights* - Preferred shareholders may have any form of modified voting rights. For example, the preferred shareholder may have the right to vote for specific corporate actions or to elect specific seats on the board of directors. In other situations the preferred shareholder may not have any voting rights.

- ***Discussion***: How do you feel about different classes of corporate ownership with different rights? What effect, if any, do you think it has in affording certain shareholders greater rights than other shareholders? Why?

- ***Practice Question***: Tom is an investor in ABC Corp. He wants to make certain that he receives a return on his investment and that other shareholders do not benefit from corporate profits ahead of him. What stock rights might Tom secure for himself when negotiating his investment?

- ***Resource Video***: http://thebusinessprofessor.com/characteristics-of-corporate-ownership-interests/

10. What are the "fiduciary duties" owed by shareholders of the corporation?

Generally, shareholders of a corporation do not owe fiduciary duties to other shareholders. This situation may change in closely-held corporations or in corporations where shareholders also serve as officers or director. State law varies as to the extent that a shareholder owes fiduciary duties to the corporation itself. A state is more likely to recognize shareholder duties to the corporation in closely-held corporations.

- *Note*: Some states hold that, in certain circumstances, shareholders owe fiduciary duties to the minority shareholders of the corporation. This is the case when a single shareholder or designated group of shareholders owns a controlling interest in the corporation. In such a case, the controlling shareholder may incur special duties to those minority shareholders.

- ***Discussion***: How do you feel about shareholder fiduciary duties, or lack thereof? Should a shareholder have greater fiduciary duties to the corporation or to minority shareholders in a closely-held corporation? Why or why not?

- ***Practice Question***: Pam is a shareholder in a closely-held corporation. She owns approximately four percent of the outstanding shares. The three other shareholders own the remaining interest equally. Do these shareholders owe any fiduciary duties to the other shareholders?

- ***Resource Video***: http://thebusinessprofessor.com/fiduciary-duties-of-corporate-shareholders/

11. To what extent are shareholders of the corporation personally liable for obligations of the corporation?

Generally, corporate shareholders are not liable for the debts or obligations of the corporation, including legal liability for torts or contract actions. Under certain circumstances, however, a court will disregard the corporate protections and hold shareholders personally liable. This situation arises when a plaintiff sues the corporate shareholder(s) alleging that the court should "pierce the corporate veil" of protection and hold shareholders liable for the corporate debts or obligations. This claim involves the "alter ego theory". Under this theory, a plaintiff must demonstrate that the purpose of the business entity is not to carry on business as a separate entity; rather, the corporate entity is simply a shell and should be considered one in the same with the shareholders. That is, the corporation is the alter ego of the shareholders and the limited personal liability protections should be disregarded. The court will ask the following questions in evaluating whether to pierce the corporate veil:

- *Business Formalities* - Did the business maintain formalities, such as organizational filings, meeting minutes, etc.?

  - *Example*: I am an officer and director of ABC Corp. I fail to file my state registration documents. I also fail to keep track of corporate records. I do not have established bylaws, and I fail to adhere to default governance rules. All of these facts can demonstrate an intent to use the corporation as a shell entity for my personal business activity.

- *Business Assets* - Did the business owners intermingle personal and business funds or other assets?

  - *Example*: I pay my personal mortgage from the business bank account without noting whether the payment is a dividend or salary compensation. Also, I routinely pay corporate expenses from my personal bank account without noting that my payment is a capital contribution to the corporate entity. This can demonstrate the corporation is a shell.

- *Business Capitalization* - Is the business adequately capitalized or does it have adequate liability protection in place?

- *Example*: As shareholder, director, and CEO, I routinely distribute any corporate profits to myself as a dividend. I leave very little funds in the corporation to finance operations. Further, I do not purchase liability insurance to cover potential legal liability, such as tort liability. If the court finds that the corporate entity form is intentionally underfunded, it may find that the entity is merely a shell for limited liability purposes.

- *Stakeholder Functions* - Did business members comply with or routinely deviate from their roles and responsibilities?

    - *Example*: I serve as director and officer. I make decisions as officer that should be reserved or the board of directors. I fail to submit major decisions to shareholder votes. This would show that I am not respecting corporate formalities and the entity form is a shell for my personal business activity.

A negative response in any or all of these situations could be grounds for the court to disregard the limited personal liability protections of the corporate entity.

- ***Discussion***: How do you feel about the limited personal liability of corporate shareholders? What do you think is the justification for affording such personal liability protection? Should a court have the ability to pierce the veil of liability protection? Why or why not? Can you think of any other questions that could be relevant in determining whether the corporation is simply the alter ego of its shareholders?

- ***Practice Question***: Clark is the a shareholder of ABC Corp. ABC Corp is being sued for the actions of an employee. Identify the conditions under which Clark could be held personally liable for the judgment against the corporation.

- ***Resource Video***: http://thebusinessprofessor.com/shareholder-personal-liability-for-corporate-obligations/

12. How can shareholders enforce their rights?

Shareholders may generally enforce their rights against the corporation (or its officers and directors) in one of two ways.

- *Direct Actions* - A shareholder may directly sue the corporation, an officer, or director if one of these individuals takes actions that result in direct harm to the shareholder. This situation is rare, because it's difficult for a shareholder to demonstrate that she has suffered a specific harm as a result of actions by the officers or directors.

    - *Example*: ABC corporation denies a shareholder the right to convert her preferred shares into common shares in accordance with her contract rights. The shareholder may personally sue the corporation, officer, or director for the harm she suffers.

- *Shareholder Derivative Suits* - In this type of shareholder litigation, the plaintiffs allege that the corporation itself was harmed by a defendant's conduct. Shareholders sue the corporation's directors or officers, alleging a breach of fiduciary duties of loyalty or care to the corporation. Any damages to the shareholders are indirect through the overall negative impact on the corporation.

    - *Example*: ABC Corporation CEO makes reckless decisions in several large corporate deals. These decisions have caused a significant decrease in stock price. Shareholders are angry and sue the CEO on behalf of the corporation. If the shareholders win, the corporation will receive a judgment against the CEO. All shareholders benefit equally from the litigation by recovering damages for the corporation.

- ***Discussion***: How do you feel about a shareholder's options for protecting and enforcing her rights? Does the ability to bring a direct action or a derivative action adequately protect shareholder rights? Why or why not?
- ***Practice Question***: Mike is a director and CEO of Murphy Corp. When Mike decides to retire, he chooses his friend David to replace him as CEO. Mike has such control and power over the board that they hire David and offer him and incredible contract without seeking the expertise of executive compensation consultants. After one year of poor performance, the Board fires David and learns that it will have to pay out the value of his contract. Shareholders are angered by the poor performance and David's payout. What are a shareholder's options to protect her rights?
- ***Resource Videos***: http://thebusinessprofessor.com/shareholder-direct-and-derivative-actions/

13. What is the process for shareholders bringing a "derivative action"?

A derivative action is a lawsuit against officers or directors brought by shareholders on behalf of the corporation. That is, the shareholders act as representative plaintiff for the corporation and sue the officers or directors for their actions resulting in harm to the corporation. While the objective of such a lawsuit is to halt certain actions by the defendants, any damages recovered in the action belong to the corporation (not the representative plaintiffs). The shareholders benefit indirectly as owners of the corporation.

Shareholder begin the derivative action process by making a request to the board of directors to bring a legal action against the alleged wrongdoer. This is called "making demand" on the board. The board will then take one of the following actions:

- *File Suit* - The board may grant the request of the shareholders and file a legal action against the officer or director allegedly causing harm to the corporation.
    - *Note*: If the board brings a legal action, the individual shareholder cannot bring a direct action.
- *Reject the Shareholder Demand* - The board may determine that bringing a legal action is not in the best interest of the corporation. The board impliedly rejects the demand or fails to respond to the demand within the statutory period (or a reasonable time). The decision of whether or not to bring a legal action is subject to the business judgment rule. As such, a board's decision of whether or not to sue is generally binding, unless the shareholders can demonstrate that the board is biased (not disinterested), not acting in good faith, acting recklessly, or acting to intentionally harm the corporation.
- *Appoint a Special Litigation Committee* (SLC) - In some situations, the board will designate a special committee of disinterested directors to make the determination of whether to bring a legal action. Generally, this shields the board from allegations of bias, bad faith, or failing to meet the standards of the business judgment rule. It is difficult for shareholders to overcome a SLC's decision and this may foreclose the ability to bring a derivative action.

In certain circumstances, shareholders may file suit without making demand to the board. If they can show that the directors have a conflict of interest, lack the independence to act in the best interest of the corporation, or have otherwise violated the business judgment rule, the court will allow shareholders to bring the derivative lawsuit without the board of directors' approval. In other words, the court will rule that "demand is futile."

- *Note*: As a practical matter, once a court rules that demand is futile, the shareholders have an advantage in the lawsuit, and the case almost always settles. On the other hand, if the court requires the shareholders make demand to the board, they are not likely to prevail and typically withdraw the case.

- ***Discussion***: How do you feel about the requirement to make demand to the board of directors to bring a lawsuit for the alleged legal violation? What standards do you think should apply to the board when making the decision of whether to pursue a legal action or no? What do you think a shareholder must show to convince the court that the board that demand is futile?

- ***Practice Question***: Thomas is upset by some decisions made by the CEO with regard to the sale of corporate assets. The CEO is also chairman of the board of directors. Thomas believes that the actions have significantly injured the corporation and its shareholders. If Thomas decides to bring a derivative action against the CEO, what is the process(es) that Thomas may follow in bringing the suit?

- ***Resource Video***: http://thebusinessprofessor.com/shareholder-derivative-action-process/

14. What are corporate vote "proxies" and how are they used?

Shareholders may vote their shares through a "written consent" or by casting their vote at a shareholder meeting. Written consents avoid the need to call a meeting, but any matter voted upon must receive unanimous written consent to be approved. In corporations with large numbers of shareholders, it is unlikely that all shareholders will attend the meetings and unanimous written consent is not likely. Thus, shareholders have the right to appoint someone to vote for them at a shareholder meeting. Both the appointed individual and the card that the shareholder signs to appoint the substitute voter are often called a "proxy". For purposes of this material, we will refer to a shareholder proxy as the card used to appoint an individual to vote the shareholder's interest. The proxy is used to solicit shareholder response and votes on a particular proposal. The shareholder may grant the proxy in favor of a particular action, such as a vote in favor of her desired candidate or corporate action. Under SEC rules, publicly-traded companies are not required to solicit proxies from shareholders, but virtually all of them do. This is the only practical way to obtain the requisite number of shareholders at a meeting to hold a vote and take action. This reaching this minimum number of shareholders present is known as obtaining a "quorum". The company must accompany all "proxy solicitations" with financial statements and a disclosures statement, known as a "proxy statement". The proxy statement contains lots of information about the corporation and any proposed actions. Much of this information is disclosed to shareholders in the annual statement and to the public *via* filing with the Securities Exchange Commission.

- *Note*: Some corporations pass what are known as "proxy access bylaws". Under proxy access bylaws, shareholders have greater ability to place information in the proxy materials sent to shareholders. Notably, large shareholders may propose individuals for election to the board of directors and these names must be included in the proxy material. These outsider nominees compete directly against directors nominated by the existing board or director nominating committee. It is, therefore, possible for an outside nominee to be elected to the board without the expense and drama of preparing separate proxy materials. So far, only a handful of companies have adopted proxy access bylaws. Shareholders have the right to require the company to take a vote at the annual meeting on changing company bylaws to permit proxy access. The proposal passes if a majority of shareholders vote in favor.

- ***Discussion***: How do you feel about the ability of shareholders to appoint a voting representative? Do you think corporations should be able to meet quorum requirements for shareholder meetings through proxies? Why or why not? Why do you think corporations are required to make such extensive disclosures along with proxy solicitations? Why do you think proxy access is not a widely adopted practice?

- ***Practice Question***: You are corporate secretary and are in charge of the administration of shareholder meetings. What process might you follow to make certain a quorum is established at the annual shareholder meeting? What information must you provide to shareholders in this process?

- ***Resource Video***: http://thebusinessprofessor.com/corporate-proxies-and-shareholder-votes/

15. What is "shareholder activism" and what is the significance of "institutions as shareholders"?

Shareholder activism refers to the situation where large shareholders of a company exert influence or control over the actions of the directors or officers of the corporation. Activist shareholders are generally concerned with improving returns on their investment through improved corporate performance or other structural changes. They may attempt to influence the company to make certain operational or governance decisions, to adopt goals or causes that the activist investor values, or to undergo a merger, acquisition, divestment or other structural change.

- *Example*: Yowser Corp is a online media and Internet search company. Yowser also has major asset holdings, such as a large stake in China Retail Online. Yowser has been declining in profits in recent years. Yowser has several activist shareholders who seek to maximize their profits. They seek to encourage the board to streamline the product offerings and to divest Yowser's ownership stake in China Retail Online. This will return a healthy dividend to shareholders, but the board fears that it will gut the company. The activist shareholders threaten to replace directors who appose the proposed plan.

Activist investors play an increasingly important role in corporate governance. In the 1920s, approximately 20% of US stocks were owned and held by institutions. Today, nearly 80% of US stocks are held by institutions (mutual funds, pension plans, hedge funds, banks, foundations, endowments, and other investment companies). Individual wealth is largely held by these third-party firms that invest a portion of those funds in corporate shares. Large corporations often directly invest their retained capital in corporate shares of other corporations, or they pay third-parties (such as State Street Corp.) to invest those funds on their behalf. This results in an inordinate amount of corporate stock holdings resting with institutional investors. This model of investment seeks to insulate the underlying investor from the risks associated with investing. More specifically, it spreads risk more evenly across large groups of investors and does not rely solely on one investment class. There is worry, however, that these arrangements place too much authority in the managers of these investment funds with regard to corporate decision-making.

- *Note*: The inordinate amount of authority that comes from holding large quantities of voting stock in corporations creates the fear that corporations and institutional investors will enter into self-serving arrangements to maximize their mutual interests. Corporate governance mechanisms attempt to mitigate this threat and protect the rights of all shareholders.

- ***Discussion***: How do you feel about activist investors? Should these investors be allowed to wield so much power over the organization? Why or why not? Does it affect your opinion whether the activist investors are individuals investing personal wealth or investment funds investing the wealth of others? Why or why not?

- ***Practice Question***: Daryl is a finance manager. He is not happy with the management performance in ABC Corp. He is contemplating raising an investment fund with the purpose of establishing an ownership stake in the company. What are Daryl's objectives and how would he be able to achieve them through this process?

- ***Resource Video***: http://thebusinessprofessor.com/activist-shareholders-and-institutional-investors/

BOARD OF DIRECTORS

16. What is the role of "directors" of the corporation?

Corporate governance procedures under state law and the Revised Model Business Corporation Act regulate the actions of boards of directors. The Organization for Economic Cooperation and Development, Principles of Corporate Governance (2004) describe the responsibilities of the board; some of these are summarized below:

- *Informed* - Stay informed of corporate affairs;
- *Ethics & Good Faith* - Act ethically and in good faith;
- *Duty of Care* - Act as a reasonable person would in the situation;
- *Duty of Loyalty* - Act in the corporation's best interest by avoiding self-dealing or usurping a corporate opportunity;
- *Planning & Guidance*- Control high-level corporation decision making, such as budgeting, strategic considerations, distribution of dividends, proposal for changes in corporation structure, etc.;
- *Executives* - Hire, determine compensation of, and oversee managers;
- *Election Process* - Oversee the process for nominating and electing directors;
- *Disclosure & Reporting* - Review and certify the accuracy of all required corporate reporting.

The amount of board responsibility varies a bit in closely-held firms. State law often allows a heightened role of directors in the daily management of operations.

- ***Discussion***: Why do you think boards of directors are vested with the above-referenced responsibilities? Should there be more or less overlap in the responsibilities of shareholders and directors? Why or why not?

- ***Practice Question***: Serena is elected to serve on the board of directors of ABC Corp. What will be her primary duties and responsibilities in this role?

- ***Resource Video***: http://thebusinessprofessor.com/role-of-directors-in-a-corporation/

17. What is the composition of the "board of directors"?

The size of the board and the process for electing directors are laid out in either the articles of incorporation or the bylaws. There are generally few requirements in these governing documents with regard to who can be a director of the corporation. Corporate governance documents generally place few or no requirements with regard to the skill, knowledge, or general competence of board members. There are, however, numerous laws and organizations that control the composition of boards of directors of public companies. These laws and organizational rules include:

- the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank),
- the Sarbanes-Oxley Act of 2002 (SOX),
- the Securities Exchange Act of 1934, as amended ('34 Act),
- rules of the U S Securities and Exchange Commission (SEC), and
- the listing standards of the NYSE and NASDAQ.

The most notable requirement of boards imposed either by law or by exchange rules is that a majority of directors on a board be "independent". The word independent is defined to mean directors who are not officers of the corporation or officers or directors of any parent or subsidiary companies. As such, independent directors are generally chosen from the executive ranks of boards of non-related public or large corporation. Another specific requirement regards corporate committees. Most notably, corporate committee members (particularly special committee members) must be disinterested in their assigned tasks. The objective behind requiring boards to have special committees is to isolate interested directors from controlling the internal workings and decision-making of the entire board. The required types of committee include:

- *Director Nominating Committee* - Charged with nominating directors for election to the board by shareholder vote;
- *Corporate Audit Committee* - Coordinates the process of audit by external auditors; and
- *Executive or Director Compensation Committee* - Tasked with developing compensation packages for officers and directors.

- ***Discussion***: Why do you think laws and securities exchanges place requirements on the composition and character of boards of directors? Do you agree with the requirement that a majority of directors be independent? Why or why not?
- ***Practice Question***: What are the primary corporate governance requirements affecting the composition of the board of directors?
- ***Resource Video***: http://thebusinessprofessor.com/composition-of-board-of-directors/

18. What standards govern the actions and decisions of the board of directors?

Aside from requirements stated in the articles of incorporation, bylaws, and detailed governance provisions laid out in the previously-referenced laws, boards of directors owe fiduciary duties to the corporation. Fiduciary duties include a duty to act in good faith in all actions, a duty of loyalty, and a duty of care.

- *Duty of Care* - Directors owe a duty of care to the corporation. The duty of care requires officers and directors to act in the best interests of the corporation and to use the same care that an ordinarily prudent person would exercise in a similar situation. This standard is similar to a negligence standard in tort cases. The duty of care requires that directors make decisions in line with three principles:
    - *Legality* - Generally, decisions by directors that violate the law also breach a duty of care to the corporation.
        - *Note*: This is true even if the illegal action is taken for the benefit of the corporation.
    - *Rational Business Purpose* - Directors must make decisions, particularly those committing resources of the corporation, based upon a rational business purpose. Most courts assume that decisions made by directors are based upon a rational business purpose.
        - *Note*: This is a very low standard, as any action could constitute a rational purpose.
    - *Informed Decision Making* - Managers must take reasonable steps to research or seek information about a situation before making a decision or taking action. An informed decision that harms the company will generally not result in liability for the director if not done recklessly or with the intention of harming the corporation.
- *Duty of Loyalty* - Managers have an obligation to act in the best interest of the corporation and without personal conflict of interest. More specifically, directors cannot take actions or make decisions that benefit themselves at the expense of the corporation. The duty of loyalty protects against self-dealing and usurping of corporate opportunities by directors.
    - *Self-Dealing* - If a director engages in self-dealing, she may be liable to the corporation for damages resulting from the action. The business judgment rule does not protect directors from liability for self-serving actions; however, corporate law does not entirely prohibit self-serving transactions. The court is charged with determining whether a transaction constitutes self-dealing and should lead to liability for the director. An affirmative answer to any of the following inquiries may avoid director liability for an otherwise inappropriate transaction:
        - *Director Approval* - Was the director's action reviewed and approved by a majority of independent directors?
            - *Note*: An approval vote from disinterested directors makes it more likely to not constitute self dealing, but it is not determinative.
        - *Shareholder Approval* - Did the disinterested shareholders approve it?
            - *Note*: If the transaction is approved by a majority of disinterested shareholders, it will not

be considered self dealing. The reasoning is that shareholders are those sought to be protected. Shareholders can vote to approve transactions that limit their own benefits?

- *Fairness* - Is the transaction fair to the corporation? That is, the corporation must not lose or forgo a right or benefit at the expense of the director's action. The court will look to determine whether the value provided to the corporation was reasonable in comparison to the value gained by the directors.

- *Example*: I am director of ABC Corp. The board is in search of land to construct a new manufacturing facility. I purchase a parcel of land that would work perfectly and immediately sell it to the corporation for a huge profit. Several members of the board approved the transaction, but the board did not submit it for shareholder approval. This is obviously a self-serving transaction. If the transaction is later challenged by shareholders, the court will closely evaluate whether the purchase price and other terms of service were fair to the corporation.

- *Corporate Opportunity* - The corporate opportunity doctrine prohibits officers, directors, and controlling shareholders from excluding their company from favorable deals. This generally means that directors cannot compete with the corporation. Competing means providing a good or service that the corporation provides. Competing with the corporation may also include providing a good or service to a prospective customer or client of the corporation where the client originally approached the corporation for that good or service.

    - *Note*: A Director may avoid liability to the corporation by showing:

        - *Offer to Corporation* - The director offered any opportunity to the corporation and a majority of disinterested directors or shareholders agreed to turn down or not pursue the opportunity; or

        - *Not a Corporate Opportunity* - The alleged opportunity was either not an opportunity at all or the corporation generally had no right or claim to it.

    - *Example*: I am a director of ABC Corporation. ABC provides tax and auditing services to clients. If a current client approaches the corporation about payroll services, I cannot provide those services to the client personally without offering it to the corporation. It would equally be a violation of my duty of loyalty if I personally offer tax and auditing services to the public while sitting on ABC's board.

- ***Discussion***: How do you feel about a director's duty of care? Should the standard of care owed to the corporation be higher or lower? Why? How do you feel about the director's duty of loyalty? Should self-interested transactions by directors be allowed? Why or why not? Does the limitation on usurping corporate opportunities go too far in limiting the abilities of directors or should it be more protective of the corporation? Why?

- ***Practice Question***: Winston is a director of ABC Corp. He is also the president of a local mortgage company. As a director of ABC Corp, Winston is a member of as special committee that makes recommendations for corporate investments. Specifically, he helps evaluate certain classes of investment for the corporation to purchase. He recommends the corporation purchase collateralized loan obligations as safe, high-yielding investments. His mortgage company sells the corporation several million dollars in bundled, collateralized loans. The corporation pays a premium for the loans because the underlying mortgages are all local. Later, the housing market crashes and ABC Corp loses lots of money. What are potential grounds for Winston's liability to the corporation?

- ***Resource Video***: http://thebusinessprofessor.com/standards-governing-actions-of-corporate-directors/

19. What is the "business judgment rule"?

The business judgment rule is a principle that applies to officers and directors acting within the scope of their positions. Directors of a corporation have a fiduciary duty to act in the best interest of their stockholders. This includes exercising due care and having a business justification for their decisions and actions. The duty of care requires officers and directors to be informed and avoid acting negligently in the execution of their responsibilities. The business judgment rule takes steps to further protect directors from liability for their decisions or actions if they acted in good faith. Basically, it raises the standard of care for holding a director liable for actions or decisions that cause a loss to the corporation. A director that takes an action or makes a decision that is negligent or reckless may be shielded from liability if they acted in good faith. Acting in good faith simply means that the officer or director genuinely believed that her decision was appropriate and in the interest of the corporation. The major limitation on the protections of the business judgment rule is when the officer or director either acts to intentionally harm the corporation or breaches her duty of loyalty.

- *Example*: I am a director of ABC Corp. I sell authorize the sale of corporate assets to members of my family at a very low price. This could be considered a self-dealing transaction. The business judgment rule will not protect me from liability for my actions if those actions are challenged by shareholders for causing a loss to the corporation.

- ***Discussion***: How do you feel about the additional protections of the business judgment rule for directors? Should directors be protected from liability when making negligent or reckless decisions? Why or why not? Why do you think the law exempts director actions or decisions that breach the duty of loyalty from protection?

- ***Practice Question***: Francis is director of ABC Corp. He, along with other directors, makes the decision to invest significant corporate assets in short-term construction loans. The loans are very high risk but yield high annual returns. Several of Francis's family members own a substantial interest in many of the construction companies benefiting from the loans. If several of the loans default and cause a loss to ABC Corp, will the business judgment rule protect Francis from personal liability? Why or why not?

- ***Resource Video***: http://thebusinessprofessor.com/what-is-the-business-judgment-rule/

20. What other protections exist for directors acting in their official capacity?

Directors (and officers) of corporations often have a layer of protection from personal liability beyond the business judgment rule. Many corporations purchase "director and officer insurance" (D&O insurance) that provides the corporation (and possibly the director or officer) with indemnification for liability for actions or decisions made in its official capacity. D&O insurance generally only applies to breaches of the duty of care. The irony of this situation is that shareholder funds are used to purchase insurance protecting officers and directors from personal liability to shareholders.

- *Note*: Public policy and state statutes often limit indemnification of officers who breach the duty of the loyalty to the corporation.

- ***Discussion***: How do you feel about the ability of a corporation to purchase insurance to indemnify it against liability caused by the actions of directors or officers? Does it matter to you that the insurance may indemnify the director or officer from personal liability? Why or why not? Does it affect your opinion knowing that the premiums for the insurance are paid by corporate funds (which belong to shareholders)? Why or why not?

- ***Practice Question***: Harold is CEO of ABC Corp. He makes personal loans to family members from corporate funds. The company sustains a loss when the borrowers default on the loans. Shareholders are angered by this and seek a derivative action against Harold. The corporation purchased director and officer insurance to cover Harold's activities as CEO. Will this protect Harold from potential liability? Why or why not?

- ***Resource Video***: http://thebusinessprofessor.com/director-and-officer-liability-insurance/

MANAGERS

21. What is the role "managers" in the corporation?

Managers control the daily operations of the corporation. The senior managers are the officers of the corporation. The most senior positions are often directly chosen by the board of directors. The board then defers to the judgment of these officers with regard to all decision making and actions taken on behalf of the corporation. This includes allowing officers to fill the subordinate management positions in the corporation. The corporate management structure generally includes any of the following senior-level positions:

- *Chief Executive Officer* - The senior management position is generally centered in a single individual, the chief executive officer (CEO). This person is ultimately responsible for all corporate operations. Other executive officers, such as the chief operating officer or chief financial officer, may report to the CEO.

- *Corporate Secretary* - The corporate secretary is the only mandatory corporate official. The board appoints and confirms the corporate secretary. She is charged with maintaining all corporate records, maintaining the minutes for shareholder and director meetings, certifying corporate documents, and orchestrating director and shareholder meetings (including all formal actions taken at the meeting).

- *Chief Financial Officer* - The CFO generally oversees all accounting and finance operations for the corporation. Oversight of the accounting process is critical, as the majority of the information disclosed to shareholders and the SEC derives from corporate accounting. Corporate finance deals with how operations of the corporation are financed, including the sources of capital and the budgets allocated to each department in the company.

    - *Note*: The chief corporate accountant (the "controller") reports to the CFO.

- *Chief Operating Officer* - The COO generally oversees all aspects of corporate operations. The role of the COO will vary considerably depending upon the nature of the corporate business. Often these individuals are subject-matter experts in the company's business practice and have extensive training in operational efficiency methods.

Other executive positions may be in charge of marketing, information or communication, technology, innovation, etc.

- ***Discussion***: How do you feel about the board of director's authority to select senior management? Why do you think corporations typically hire executives in this operational structure to oversee the primary corporate functions? Can you think of any structures that could arguably operate better than this structure?
- ***Practice Question***: What is the role of the chief executive officer and corporate secretary, and how do their roles relate to corporate governance?
- ***Resource Video***: http://thebusinessprofessor.com/role-of-managers-of-the-corporation/

22. What standards govern the actions of corporate managers?

Like the corporate directors, officers of the corporation owe fiduciary duties to the corporation. Officers must demonstrate loyalty and care in carrying out their responsibilities. The standard of care that an officer must observe in carrying out her duties varies considerably given the wide array of officer responsibilities; but, the officer must generally be informed and not act negligently. Similarly to corporate directors, officers are protected in their actions by the business judgment rule. Further, most corporation purchase insurance to indemnify officers and directors for any personal liability for actions taken on behalf of the corporation.

- *Note*: Recall from the previous discussion of the business judgment rule, the primary limitation is that the insurance does not indemnify against breaches of the duty of loyalty.

- ***Discussion***: How do you feel about the standard of care owed by officers to the corporation? Should the business judgment rule protect officers in their decisions and actions in the same manner that it protects directors in their decisions? Why or why not?
- ***Practice Question***: Amy is CEO of ABC Corp. She decides to hire her cousin as the corporate COO. Her cousin has little experience in the position. When operations begin to lag, the board forces her hand in firing her cousin. The terms of his employment entitle him to 3 years worth of compensation if fired for any reason. The board is angry that Amy did little to vet her cousin prior to hiring him and that his compensation package was poorly negotiated. What standards will apply in determining whether her conduct breaches a duty owed to the corporation.
- ***Resource Video***: http://thebusinessprofessor.com/standards-governing-actions-of-corporate-officers/

LAW AND CORPORATE GOVERNANCE

23. What state and federal laws primarily contribute to corporate governance?

Regulation of corporate governance practices is a mixture of state and federal law and organizational requirements. Below is a list of the primary state and federal laws and stock exchange rules contributing to corporate governance:

- state-specific corporate laws (particularly Delaware law and Model Business Corporation Act states),
- the Securities Exchange Act of 1934 ('34 Act) and SEC Rules,
- the Sarbanes-Oxley Act of 2002 (SOX)
- the Foreign Corrupt Practices Act (FCPA)
- the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank),
- the listing standards of the NYSE and NASDAQ
- the advisor rules from Proxy Advisory Firms.

Each of the above sources of regulation are discussed in detail below.

- ***Discussion***: If corporate entities exist by virtue of state law, why do you think that there are so many federal laws and private organization standards concerning corporate governance?
- ***Resource Video***: http://thebusinessprofessor.com/state-and-federal-corporate-governance-laws/

24. What is the role of state law in corporate governance?

State corporate law is the primary law governing corporate governance and operations. Each state passes its own statutory corporate laws and develops its own common law surrounding those statutes. Shareholders seeking to bring actions to enforce their rights must generally do so under state law. Many state legislatures, rather than independently drafting corporate statutes, adopt the Model Business Corporations Act (MBCA) as the default corporate law in that state. The MBCA is a model set of laws prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association. Twenty-four states have chosen the wholesale adoption of the MBCA. This practice has added a degree of uniformity to state statutory law across state borders.

A corporation may incorporate in any state, whether or not the corporation carries on business in that state. This is a common practice when a corporation wishes to take advantage of a state's favorable legal environment for businesses operations. The most common state for incorporation by businesses that operate primarily outside of that state is Delaware. That is, many corporations (particularly public corporations) incorporate in Delaware but establish their headquarters in other locations. Delaware does not follow the MBCA, and corporations organizing in Delaware do so with the purpose of availing themselves with Delaware's corporate governance provisions and court system. Delaware allows for several legal benefits that make it a popular choice for companies headquartered in other states, including:

- *Developed Corporate Law* - Delaware has an extensive body of corporate law (statutory and common law) that is generally considered to be more thoroughly developed than other states. While the point is debatable, many argue that the Delaware body of corporate law is more favorable to managers (officers and directors) than shareholders.
- *Legislative Responsiveness* - The Delaware legislature prioritizes corporate law by reacting quickly to propose legislation dealing with important issues. This is important when gaps in statutory law could lead to uncertainty in corporate governance or procedure.

- *Chancery Court* - Delaware has a dedicated chancery court to hear corporate law matters. This is an executive court controlled by chancellors (judges) who are experts in corporate law. The chancery court does not allow for jury trials, so the chancellor serves as fact finder in legal disputes before the court.

All of the factors provide greater degrees of certainty and comfort to corporate managers and directors.

- ***Discussion***: Why do you think corporations prefer to have a well-developed body of corporate law? Why do you think corporations prefer to adjudicate legal disputes involving corporate law before a chancellor rather than a jury? Why do you think that the legislature is so responsive in acting upon corporate law issues? (Hint: Think about the nature of statutory law versus common law.)

- ***Practice Questions***: Why do many corporations organize in Delaware as apposed to their primary states of operation?

- ***Resource Video***: http://thebusinessprofessor.com/state-law-and-corporate-governance/

25. What is the role of "securities laws" in corporate governance?

Federal securities laws are generally concerned with corporate compliance. The primary federal securities laws are the Securities Act of 1933 ('33 Act) and the Securities Act of 1934 ('34 Act). State law also governs the sale or exchange of securities, but state law largely mimics or piggybacks upon federal securities law. The '33 Act primarily controls the initial issuance of securities. In private corporations, the '33 Act places numerous governance requirements on corporate stakeholders during the issuance process. The '34 Act places significant requirements on the reporting and disclosure of information by publicly-held corporations. These provisions include mandatory reporting to the Securities and Exchange Commission, as well as disclosure requirements to corporate shareholders. The corporate directors and officers are primarily tasked with making and ensuring the accuracy of all securities-related disclosures. Notably, the '33 and '34 Acts allow for a cause of action by shareholders against the corporation or its agents for failure to make disclosures, omissions, or material inaccuracy in a disclosure. These causes of action are based upon negligent misrepresentation and fraud (intentional misrepresentation) in connection with the purchase or sale of corporate securities. The causes of action available to shareholders under the '33 Act and '34 Acts are discussed in greater detail in a separate chapter.

- ***Discussion***: Why do you think corporate compliance with securities law is an important consideration in corporate governance? How does compliance affect each stakeholder (shareholder, director, officer) in the corporate governance regime?

- ***Practice Questions***: What are the corporate governance requirements relevant to federal securities laws?

- ***Resource Video***: http://thebusinessprofessor.com/corporate-governance-and-federal-securities-laws/

26. What is the "Foreign Corrupt Practices Act" (FCPA) and how does it affect corporate governance?

The Foreign Corrupt Practices Act (FCPA) places limitations on the ability of the corporation to pay incentives or bribes to foreign governments and corporate officials to secure business advantages.The regulations place specific requirements on corporate accounting departments to account for foreign payments and on corporate directors and managers to adequately disclose those payments to regulators and shareholders. Failure to do so may result in criminal and civil penalties.

- ***Discussion***: How do you think the FCPA affects decision making and actions by officers and directors of corporations seeking to do business internationally?
- ***Practice Question***: What are the primary corporate governance issues implicated by the Foreign Corrupt Practices Act?
- ***Resource Video***: http://thebusinessprofessor.com/corporate-governance-and-the-foreign-corrupt-practices-act/

27. What is the "Sarbanes-Oxley Act"?

The Sarbanes-Oxely Act (SOX) is the primary federal law governing corporate governance and accountability across multiple aspects of corporate business practice. SOX specifically regulates markets, brokers, dealers, accounting and auditing, on-going government and shareholder disclosure by reporting companies, insider trading, anti-fraud, proxy regulation and so forth. SOX established a new regulatory body, increased the authority of existing regulators, as well as imposed regulations beyond those of the self-regulating, industry organizations. The primary objectives of SOX are to promote:

- *Fairness to Shareholders* - SOX requires or promotes governance provisions that protect shareholder rights and allow shareholders to exercise those rights through governance procedures, such as shareholder meetings.
- *Fairness to Stakeholders* - SOX requires or promotes governance provisions that take into consideration the interests of employees, suppliers, buyers, and the local community.
- *Heightened Director and Board Responsibilities* - SOX places specific requirements on the composition of boards of directors, including skill and independence requirements. Notably, in an effort to promote director independence in decision making, SOX requires corporations to employee committees for special purposes.
    - *Example*: SOX requires boards appoint an audit committee where all members are independent of corporate operations (not officers of the corporation) with at least one financial expert as a member of the committee.
- *Director and Officer Ethics* - SOX imposes additional obligations on corporations to establish and maintain ethical standards for officer and director conduct and decision-making.
    - *Example*: SOX prohibits the corporation from making personal loans to corporate executives or their families.
- *Disclosure and Accountability* - SOX places requirements on boards to increase transparency in corporate governance practices. This includes implementing procedures for ensuring accurate accounting practices and public disclosure mechanisms.

- *Note*: SOX requires internal review procedures and independence of external auditors that report directly to the corporation's independent audit committee. Further, SOX requires that key officers of the corporation (the CEO and CFO) certify the accuracy of the financial statements and that internal financial controls are in place and subject to the independent audit committee's review.

Accounting and Disclosure Procedures - SOX imposed a number of reforms on the accounting and financial reporting requirements of public companies. The primary requirements are as follows:

- *The Public Company Accounting Oversight Board (PCAOB)* - SOX established the PCAOB to regulate auditors charged with reviewing the accounting procedures and disclosure statements of public companies.
    - *Note*: Prior to the establishment of the PCAOB, public company auditors were self-regulated or subject to the standards imposed by private institutions, such as the Financial Accounting Standards Board (FASB) or American Institute of Certified Public Accountants (AICP).
- *External Auditing Firms* - SOX now requires that a firm in charge of auditing the corporation refrain from serving as independent consultants to that same firm. This includes refraining from bookkeeping, system designs and implementation, appraisals and valuations, actuarial services, human resources functions, and investment banking services for the audited company. Further, the corporation must change auditing firms at least every 5 years. There are also restrictions on the ability of company executives to have worked for the auditing firm within the prior year.
    - *Note*: Prior to SOX, external auditing firms could simultaneously serve as consultants to the corporation that it is auditing. The created an inherent conflict of interest. Further, allowing corporations to employ the same auditors for extended periods increased the likelihood that on-going, improper accounting practices would not be discovered. Without periodically rotating in new auditors, there was no real check on the accounting firm.

Securities Regulations - Much of the regulatory process prescribed by SOX is carried out by the Securities and Exchange Commission. SOX includes provisions that strengthen the ability of the SEC to oversee corporate governance matters and enforce violations.

- *Example*: SOX established a criminal charge for conspiring to commit securities fraud. It also increased the criminal and civil penalties for committing securities fraud. SOX provides additional protections against discrimination for those reporting conduct that violates the securities laws ("whistleblower protection").

- ***Discussion***: What do you think was the driving force behind the passage of SOX? Why do you think focused on accounting standards and securities regulations to promote its objectives of fairness and ethics?
- ***Practice Question***: What are the primary corporate governance requirements and objectives of these requirements under the Sarbanes-Oxley Act?
- ***Resource Video***: http://thebusinessprofessor.com/corporate-governance-and-the-sarbanes-oxley-act-sox/

28. What is the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (Dodd-Frank)?

Dodd-Frank was passed in response to the financial downturn beginning in 2007. While Dodd-Frank imposed extensive controls on banks and other lending institutions, it also prescribed corporate governance procedures designed to protect shareholder interests. Notable provisions of Dodd-Frank include:

- *Proxy Rights* - Requires corporations allow shareholders have greater ability to nominate directors for election to the board in corporate proxy material.
- *Proxy Disclosures* - Requires corporations to make more extensive shareholder disclosures in all corporate proxies.
- *Shareholder Voting Rights* - Entitles shareholders to a non-binding vote on certain corporate governance issues.
    - *Note*: Shareholders may be entitled to cast votes on the proposed hiring and compensation of corporate executives. While these votes are not binding, they do allow the shareholders to openly evaluate and express their opinions on corporate governance matters.

- ***Discussion***: Why do you think a Act that intends to protect the market against financial downturn imposes shareholder rights provisions on corporations? Can you explain how any of these provisions help make securities markets more stable?
- ***Practice Questions***: What specific corporate governance procedures are required by the Dodd-Frank Act?
- ***Resource Video***: http://thebusinessprofessor.com/corporate-governance-and-the-dodd-frank-act/

29. What industry organizations place standards on corporate governance?

- Public securities exchanges have extensive governance requirements for companies listing securities for sale with the exchange. Perhaps the most known US exchanges are the New York Stock Exchange ("NYSE") and NASDAQ Stock Market ("NASDAQ"). Common exchange provisions require:
    - *Director Independence* - Exchanges require that listed companies maintain director independence, which includes independence from management and financial relationships with the corporation;
    - *Committees* - Companies may be required to comply with strict committee requirements, such as appointment of specific committees with director independence and defined charters (such as governance committee, audit committee, compensation committee);
    - *Shareholder Votes* - Companies may be required to allow shareholder vote on specific matters, such as modifications of governance conditions and equity distributions;
    - *Equity Structure* - Companies may be required to adhere to specified equity structures that limit the rights of various classes of shares;

- *Management Restrictions* - Companies may be required to hold separate director meetings that exclude directors who are also managers; and

- *Public Disclosures* - Companies may be required to comply with standards for public disclosure of information, including the manner and frequency of disclosure.

The regulatory authority of exchanges comes from the exchange's ability to control which companies are listed on the exchange. Exchanges may reprimand, suspend, or bar companies from listing their shares for violations of exchange rules.

- ***Discussion***: Why do you think securities exchanges are concerned with corporate governance matters? Can you explain how each of the above areas of regulation support this objective?

- ***Practice Question***: What are the some of the primary governance requirements placed on corporations by industry organizations?

- ***Resource Video***: http://thebusinessprofessor.com/corporate-governance-and-industry-standards/

30. What are "proxy advisory firms" and what is their effect on corporate governance?

Recent changes to corporate governance laws allow shareholders increased ability to add information to corporate proxies. As a result, proxy advisory firms have assumed an important role in the shareholder proxy solicitation and notification process. These firms propose governance standards for corporations. They encourage corporations to adopt and comply with those standards by sending information to all corporate shareholders about the corporation's governance. These standards will indicate when directors adhere to or deviate from the proposed governance standards. They may also include a recommendation for director elections. This practice pressures directors to conform to governance standards or face a recommendation from the advisory firm against election or re-election. These firms serve a very important function by informing shareholders who otherwise lack the ability or motivation to learn about directors proposed by the nomination committee of the corporation.

- *Note*: Activist shareholders may employ proxy advisory firms to promote their agenda to shareholders.

- ***Discussion***: What is the advantage to activist investors who employ proxy advisory firms? Do you think that these firms can have positive or negative effects on corporate governance? Why or why not?

- ***Practice Question***: How doe proxy advisory firms influence the corporate governance process?

- ***Resource Video***: http://thebusinessprofessor.com/corporate-governance-and-proxy-advisory-firms/

31. What is the role of ethics within corporate governance?

Corporate codes of ethics are internal measures aimed at ensuring fair and honest conduct by members of the corporation. The corporate law objective to promote openness of information is echoed in codes of ethics. The main problems with codes of ethics are that they do not force compliance and there is very little consequences for individuals failing to adhere to their provisions. As such, corporate actors routinely avoid these provisions in favor of self-interested actions.

- *Note*: These codes, however, may serve as the standard by which corporate members are judged in the event of direct or derivative actions against the corporation or the member.

- ***Discussion***: Why do you think corporations establish codes of ethics? Do you think they are effective? Why or why not? Should there be repercussions for failure to adhere to corporate ethics policy? Why or why not?

- ***Practice Question***: How do rules of ethics affect corporate governance practice?

- ***Resource Video***: http://thebusinessprofessor.com/corporate-governance-and-ethics/

CAUSES OF CORPORATE GOVERNANCE ISSUES & TECHNIQUES FOR EFFECTIVE PRACTICE

32. What are some of the major causes of corporate governance issues?

The primary characteristics of the corporate governance regime that causes issues or conflicts between shareholders and the corporation are as follows:

- Access to Information
- Decision-Making Procedure
- Competition for Authority
- Interest and Benefit Misalignment

Each of these drivers of corporate governance issues is discussed below.

33. How does shareholder access to information give rise to issues in corporate governance?

Shareholders own the corporation and control the election of directors. While this structure should effectively check the decision making and actions of directors, the lack of shareholder information about the actions and decisions of directors prevents them from making accurate decisions and often causes apathy with regard to exercising their voting rights. The lack of information is amplified by the fact that nomination committees within the corporation often have unilateral authority to recommend a director for election to the board. Couple this with the fact that shareholders have limited access to proxy material to make shareholder proposals, it makes it unlikely shareholders will be effective in influencing director actions. In light of this reality, shareholders must either possess a large share of corporate ownership or assemble into voting groups to have any real influence on the actions and decision-making of directors. A large shareholder or large voting block has the ability to pass resolutions and control the election of directors. It is often difficult, however, for shareholders to effectively aggregate into a strong voting block in the corporation. One reason is the lack of available information and the high cost of obtaining and monitoring that information. For this reason, increased shareholder access to proxy material, additional shareholder voting rights, and the role of proxy advisory firms has become very important.

- ***Discussion***: What do you think are the potential advantages and disadvantage to allowing shareholders greater access to corporation information? What would be the potential effect on the corporation? Other stakeholders?

- ***Practice Questions***: What are the primary reasons for shareholders having limited access to information, and how does this lead to conflicts between shareholders and investors.

- ***Resource Video***: http://thebusinessprofessor.com/lack-of-information-and-corporate-governance-issues/

34. What corporate decision-making procedures give rise to issues in corporate governance?

The structure and process for decision making within the corporation can lead to conflicts between officers and directors and shareholders. Below are common decisions or processes that give rise to conflict:

- *Corporate Approvals* - Certain approval rights for board actions are reserved to shareholders. That is, shareholders must approve the decision of directors. These checks on authority can often cause tensions between shareholders and those in charge of corporate governance. This conflict is exacerbated by the fact that shareholder voting must often be initiated by a proposal from the board of directors.

    - *Example*: An attempt by shareholders to amend the bylaws or articles of organization must begin with a proposal from the board of directors. Further, a proposed merger, acquisition or spin-off must be approved by a majority of shareholders.

- *Capital Distribution* - Shareholders, as owners of the corporation, receive a financial benefit through either a distribution of dividends from corporate profits or an appreciation of their ownership interest. As you will learn in finance, appreciation of the value of stock is generally based upon the expectation of future dividends from corporate profits. Directors are charged with the decision of whether, when, and the amount of dividends to distribute to shareholders. This fact often causes conflict between large shareholders and directors.

    - *Example*: Adam is a large shareholder who purchased stock in the corporation for the expected dividend. The corporation is going through some strategic transitions and expects to withhold all dividends and retain capital to acquire competitors. These acquisitions are risky and run counter to Adam's objectives in holding the stock.

- *Proxy Statements* - The control that the board of directors (and the nominating committee) exercises over proxy material creates a conflict between director preferences and the ability of shareholders to make proposals for approval to shareholders at large.

    - *Note*: Directors, even those on a nominating committee, often have loyalty or are indebted to the individuals who assisted them in becoming a part of the board. These directors may feel pressure to nominate potential directors who have the support of the individuals who supported them.

    - *Example*: Eric is CEO and a director on the board of ABC Corp. He supported several of the independent board members in their election to the board. These directors typically work at board meetings for 3-5 days per month and receive tens to hundreds of thousands of dollars per year in salary and benefits for their service. As such, the directors owe a significant debt of gratitude to the CEO. It is unlikely that these directors will fail to support the CEO's future nominees to the board.

- *Written Consents* - Directors and shareholders have the ability to act pursuant to written consents instead of holding a formal meeting to take a vote. These votes require either a majority or unanimous vote from directors or shareholders. Taking actions without meeting reduces the level of information distributed and can lead to conflicts between interested parties.
    - *Example*: The board of directors for ABC Corp intends to make a decision on a major environmental cleanup project. It submits the proposed project to shareholder vote. Instead of holding a meeting, they accept votes through written consent. The majority of votes cast were adamantly against the proposal and it fails to pass, as it would decrease short-term corporate profits.
- *Supermajority and Unanimity Requirements* - Often shareholders and directors establish governance standards requiring unanimous or supermajority approval of certain corporate actions. These requirements may lead to conflict and stalemates between interested parties with regard to corporate decisions and actions.
    - *Example*: Earl is a major corporate shareholder. He strongly supports a proposed corporate merger that has been submitted to shareholders for approval. Several smaller shareholders have decided that they do not support the deal. Because the board employed unanimous shareholder approval rules, the proposed merger will not receive shareholder approval. Earl is now furious and is considering his options for forcing out directors who refuse to support an amendment to the unanimous shareholder approval requirements.

- ***Discussion***: Do you see a common thread among the procedural aspects that give rise to corporate governance issues? Why do you think this is the case? Of the governance procedures listed above, do believe that any should sway in favor of director or shareholder? Why or why not?
- ***Practice Question***: What corporate governance rules or procedures for decision making give rise to conflicts between shareholders and directors?
- ***Resource Video***: http://thebusinessprofessor.com/decision-making-and-corporate-governance-issues/

35. How does competition for authority within the corporation give rise to issues in corporate governance?

The corporate structure is designed to establish limited authority in shareholders, directors, and officers. While the general responsibilities of each are clearly established, the strength of influence on decision making is often distorted by the amount of authority demanded or exercised by each stakeholder.

- *Internal Power Struggles* - The most notable power struggles come between the board of directors and shareholders. These matters are often settled through shareholder votes or derivative actions by shareholders against the board. In this process, shareholders may seek to assert additional control over director decision making; while directors often seek to diminish shareholder input.
    - *Note*: Shareholders do not approve of a strategic course for the corporation as decided by the directors. Shareholders seek to exert influence over the directors to influence their decision making or request that certain actions be submitted to shareholder vote for approval. If the directors decline to follow shareholder urging and it leads to a corporate loss, shareholders have the option of bringing direct or

derivative actions against the directors. Further, shareholders may seek to unseat uncooperative directors at election time.

- *Friendly Takeovers* - A common point of conflict may arise between the existing board of directors and prospective acquirers (purchasers of a controlling percentage of outstanding shares) of the corporation. This transaction is known as a corporate "takeover" or "buyout". A takeover is where third parties purchase the outstanding shares of corporate stock and thereby gain control of the corporation. The prospective acquirer(s) may be unrelated third parties, managers, or existing shareholders. The acquirer may petition the board of directors to accept a takeover bid. If the board endorses the offer, it will submit the proposal to existing shareholders. If a majority (or supermajority) of shareholders approve the purchase, the board will repurchase all of the outstanding shares from shareholders at the proposed price. The shares are then surrendered to the acquiring firm. If, however, the board or shareholders reject the acquirer's offer, the acquirer may seek alternative methods to acquire control over the corporation, such as through a "hostile takeover".

    - *Note*: In some cases, a takeover can appear to be friendly but is really hostile. For example, a "bear hug" is a situation where an acquirer offers a purchase price to the board that is far above expected value. The board may be required to accept or endorse the offer in order to meet its obligations to represent the best interest of shareholders.

    - *Example*: I am an activist investor. I see opportunity for creating value in ABC Corp. I make a tender offer to the board to purchase all (or a majority) of outstanding corporate shares. Directors will evaluate the offer and either accept or reject it. In some case, directors are obligated to submit the offer to shareholders for approval or rejection.

- ***Discussion***: Why do you think power struggles between shareholders and directors often lead to corporate governance issues? Do you believe that the default division of corporate responsibilities is efficient in avoiding or reducing these types of struggles? Why or why not? How do you feel about the concept of a takeover bid from prospective shareholders? Should directors be obligated to submit any offer to shareholders for approval or rejection? Why or why not?

- ***Practice Question***: Karl is an activist investor who regularly assumes a large ownership stake in corporations in order to make changes in the corporations that will drive value and produce a return on his investment. He looks at ABC Corp and believes that the CEO is causing a loss of corporate value. He believes that he could replace the CEO with a higher performer and instantly create significant value in the corporation. He could then sell his shares and make a hefty profit. What are Karl's first steps in achieving his objectives?

- ***Resource Video***: http://thebusinessprofessor.com/power-struggles-and-corporate-governance-issues/

36. What is a "hostile takeover" and what effect does it have upon corporate governance?

A hostile takeover is where a third-party acquirer seeks to purchase a controlling number of outstanding shares without the endorsement or approval of the target company's board of directors. Prospective shareholders can carry out their objectives through a number of methods.

- *Strategies for a Hostile Takeover* - Acquirers often employ numerous methods to circumvent the board and affect the intended acquisition.

- *Tender Offer* - The primary method of acquiring a controlling share of a corporation's stock without the approval of the board is done through an open offer to shareholders to purchase shares at a given price. This is known as a "tender offer". Once the acquirer obtains a sufficient number of shares, it will begin to elect new directors to the board of directors. The new directors will represent the interests of the acquirer. This effectively puts the acquiring shareholder in control of the corporation.

    - *Note*: Tender offers are regulated by federal law. The Williams Act requires that an attempted tender offer be registered with the SEC.

    - *Example*: 123 Corp wants to buy ABC Corp. 123 Corp registers with the SEC and makes an open offer to all ABC Corp shareholders to purchase their shares at $72 per share. The offer is contingent upon 123 Corp receiving a commitment from a certain number of shareholders to sell their shares. If 123 Corp is successful in acquiring a majority of outstanding corporate shares, it will then begin electing directors who will approve 123 Corp's acquisition plan.

- *Proxy Contest* - A potential acquirer may attempt to convince existing shareholders to replace the current directors with directors that support the acquirer's objectives. This is done by placing the name of the acquirer's proposed director nominee in the shareholder proxy material. If the proxy material is successful, a majority of shareholders will elect the acquirer's director(s), who will then work to effectuate the takeover plans.

    - *Note*: Acquirers must often initiate litigation to enforce shareholder proxy right provisions. As previously discussed, these provisions effectively strengthen shareholder access to proxy material. It allows the acquirer to provide shareholders with the option of approving the acquirer's objectives.

    - *Example*: 123 Corp makes an offer to ABC Corp's board to purchase all outstanding shares of ABC Corp at $23 per share. ABC Corp refuses the offer. 123 Corp purchases a large block of shares of ABC Corp and thereby has shareholder rights. 123 Corp then exercises its right to add its recommended directors to the corporate proxy material. This allows shareholders to vote for 123 Corp's proposed directors. If successful, the 123 Corp proposed directors will vote to approve 123 Corp's acquisition plan.

- *Creeping Tender Offer* - In some cases, an acquirer may begin to slowly acquire corporate shares on the public market. Once the shareholder reaches a sufficient number, it can begin the process of replacing existing directors with directors who will support the acquirer's objectives.

    - *Note*: Depending upon the amount and how quickly a potential acquirer purchases shares, it may have to register its intent with the SEC. In any event, acquisition of a certain percentage of corporate shares triggers a number of disclosure requirements.

- *Bear Hug* - In some cases, a takeover can appear to be friendly but is really hostile. For example, a "bear hug" is a situation where an acquirer offers a purchase price to the board that is far above expected value. The board may be required to accept or endorse the offer in order to meet its obligations to represent the best interest of shareholders.

- *Example*: ABC Corp wishes to purchase 123 Corp and merge operations. ABC Corp realizes that the board of 123 Corp is not interested in a merger or acquisition. As such, ABC Corp offers a very high purchase price for the 123 Corp shares. The board must consider this proposal. If 123 Corp rejects the offer, shareholders who are unhappy with the decision may bring a derivative action against shareholders or vote against them in future director elections.

- ***Resource Video***: http://thebusinessprofessor.com/what-is-a-hostile-takeover/

- *Anti-takeover Measures* - When an acquirer attempts a hostile takeover, boards of directors commonly institute measures to thwart the acquirer's attempts to gain control of the corporation. Some common measures employed are as follows:

  - *Shark Repellants* - These provisions strengthen the board and make it increasingly difficult for the acquirer to effectuate its plan of replacing current directors.

    - *Staggered Boards* - The election of directors is staggered over a multi-year period. A certain number of directors will be elected at each annual meeting. This will lengthen the amount of time it would take a bidder to gain full control over the board.

      - *Example*: ABC Corp has 9 directors. Only 3 directors come up for election each year. At a bare minimum, it would take two years before a majority shareholder would be able to elect 5 directors and obtain a majority on the board.

    - *Super-majority Voting* - This means that the proposed action requires a higher number of shareholder votes than a simple majority. This will mean that the hostile acquirer must purchase or obtain a proxy from a larger number of shareholders in order to effectuate the takeover.

      - *Example*: ABC Corp amends the articles of organization or bylaws to require an 80% approval of shareholders for any merger, acquisition, or sale of substantially all of the corporation's assets. This means that an acquirer would have to acquire a much larger share of the outstanding shares in order to effectuate the takeover.

- ***Resource Video***: http://thebusinessprofessor.com/hostile-takeover-defense-shark-repellant/

  - *Poison Pills* - These provisions have the objective of raising the cost of acquisition to the acquirer in hopes of making the acquisition prohibitively expensive.

    - *Preferred Share Issuances* - The board may approve a preferred class of shares that grant extensive rights to existing shareholders. The preferred shareholder may generally exercise her rights in the event of a takeover offer or a purported acquirer obtains a controlling block of shares.

- *Note*: Types of preferred share issuances include "flip-over plans" and "flip-in plans". The flip-over plan allows the preferred shareholder to convert or purchase common shares at a very low cost. In flip-in plans, the shareholder can force the corporation to repurchase the preferred shares at a premium. Both of these provisions cost the acquirer lots of money.

- *Dual Class Recapitalization* - The board distributes a new class of equity to stockholders with superior voting rights but inferior dividends or marketability. The new shares allow shareholders to exchange these shares for some multiple (2x, 3x, etc.) of ordinary common stock. This will augment the voting power of existing managers and make it more difficult for an acquirer to obtain a controlling block of shares.

    - *Example*: I receive preferred shares that allow me numerous votes per share and the ability to convert the preferred shares into large numbers of common stock. This gives me an inordinate amount of voting power for the price of the share.

- *Employee Stock Ownership Plans* - This plan may allow employee (particularly executive) stock plans to vest at an accelerated rate. These types of plans are known as "golden parachutes". They force the acquirer to purchase far more shares at a higher valuation.

    - *Example*: I am CEO of ABC Corp. In my employment contract, I reserved the right to receive 10 years worth of compensation in stock options that vest immediately if I am relieved from my position without cause. If ABC Corp is acquired in a hostile takeover and I am replaced as CEO, this could cause substantial expenses to the corporation. If this provision is included in the contract of enough senior managers, it could make an acquisition unattractive.

- ***Resource Video***: http://thebusinessprofessor.com/hostile-takeover-defense-poison-pill/

- *Buying Off Acquirer* - Often the corporation will attempt to provide benefits to the acquirer that will incentivize it to give up its efforts. These efforts are generally not in the best interest of existing shareholders and can lead to litigation.

    - *Target Share Repurchase Plans (Greenmail)* - In some cases the corporation will attempt to repurchase of block of shares held by an intended acquirer. The acquirer heavily profits from the repurchase. This effectively eliminates the acquirer from continuing with the acquisition plan.

        - *Example*: I purchase a large block of shares in an effort to acquiring a controlling interest in the corporation. The corporation repurchases the shares at a 25% premium above my purchase price. I sell the shares and abandon my share acquisition efforts.

    - *Standstill Agreements* - The board may offer to pay an acquirer to halt the acquisition of additional shares for a state period of time. The provision may also require the acquirer to vote its shares for the current board of directors. This will give the corporation time to implement additional anti-takeover measures.

- *Example*: ABC Corp pays Karl to cease acquiring additional shares in ABC Corp for 12 months. This allows the directors the opportunity to propose changes to the governing documents to implement additional anti-takeover measures. Often these measures require existing stockholder approval, so the standstill agreement will require Karl to vote for the implementation of these provisions.

- ***Resource Video***: http://thebusinessprofessor.com/hostile-takeover-defenses-delay-tactics/

- *Legal Lockups* - The corporation may be able to halt or delay the acquisition by making it less lucrative to the acquirer or making it illegal under existing law.
    - *Asset Restructuring* - The corporation may be able to acquire assets that the acquirer does not want or that will create antitrust problems. Alternatively, the corporation could sell valuable assets that the acquirer desires, thus making the acquisition less valuable.
        - *Example*: ABC Corp sells valuable assets to a friendly, third party. If the acquirer is doing so in hopes of creating value through a strategic acquisition of corporate assets, the sale of these assets may reduce the strategic value of the firm for the acquirer.
    - *Litigation* - The corporation may seek a legal action through the FTC or SEC alleging that a merger or takeover violates antitrust or securities laws.
        - *Example*: ABC Corp purchases a competitor of the acquiring firm. If the acquirer effectively gains control over ABC Corp, the Federal Government may review the acquisition to make certain it does not violate antitrust law. If the acquisition results in a concentration of market power in the acquirer, the government may block the acquisition.

- ***Resource Video***: http://thebusinessprofessor.com/hostile-takeover-defenses-asset-or-liability-tactics/

- *Alternative Acquisition Defenses* - In some cases, a corporation may seek to acquire or be acquired in an alternative arrangement that thwarts the acquirer's efforts.
    - *White Knight Defense* - In some cases the board may go so far as to endorse acquisition by a different acquirer. The endorsed acquirer does so to avoid the corporation falling into the hands of the original intended acquirer. This process is known as a "white-knight" defense to a hostile takeover.
        - *Example*: ABC Corp has a close relationship with 123 Corp. In order to fend off an

acquirer, ABC Corp endorses a merger or acquisition by 123 Corp. This may make acquisition of shares too expensive and impractical for the acquirer.

- *Pac-Man Defense* - The target corporation may seek to acquire the acquirer, if the acquirer is a public corporation with stock available for purchase. This is a sort of counter attack that may thwart the takeover effort.

  - *Example*: 123 Corp makes a tender offer for ABC Corp shares. ABC Corp board is not interested in combining with 123 Corp. They do, however, recognize that a combination could product substantial value. ABC Corp, in turn, makes a tender offer for 123 Corp stock. If this offer eclipses the expected increase in share value of 123 Corp after acquiring ABC Corp, then ABC Corp may be able to successfully fend off 123 Corp's offer.

- ***Resource Video***: http://thebusinessprofessor.com/hostile-takeover-defenses-white-knight-and-pac-man/

The above list is not exhaustive, but it provides larger categories for types of defenses employed by boards of directors to thwart takeovers. In some cases, these takeover attempts are directed against existing shareholders or managers that seek to gain control of the corporation. A management takeover is generally carried out as a 'leveraged buy-out'. A leveraged buyout is when managers use a combination of debt and private investment capital to purchase a controlling interest of the corporation. Generally, debt used to purchase the corporate shares is secured by assets of the corporation.

- ***Discussion***: How do you feel about the ability of third parties to undertake a hostile takeover? Do you believe that hostile takeovers are a benefit or detriment to existing shareholders? Should directors be able to fight against the takeover? Why or why not?

- ***Practice Question***: If Karl wants to acquire a controlling interest in ABC Corp and the board rejects his tender offer, what are his options for undertaking a hostile takeover? If the corporate directors seek to defend against Karl's takeover efforts, what are their options?

37. How does the alignment of benefits and interests cause corporate governance issues?

Officers, directors, and shareholders often have competing interests as stakeholders of the corporation. Examples of such conflicts are as follows:

- *Officer-Directors* - The board of directors is charged with hiring the chief executive officer (and potentially other executives). An inherent conflict exists when the CEO is also a director of the corporation. This conflict is especially evident when the CEO is chairman of the board or a large shareholder. The responsibilities and interests inherent in each of these roles often times conflict.

  - *Example*: Mark is CEO and a director of ABC Corp. He receives several million dollars per year in compensation for his role as CEO. When the corporation receives an offer from a hostile takeover, he opposes the sale of the corporation because he will lose his job. Even though he is charged as director with representing the best interests of shareholders, he votes his personal interest in opposing the merger.

- *Officer-Director Compensation* - The board of directors is charged with hiring and approving the compensation of officers. Further, members of the board set the compensation of other board members. Compensation for these individuals is generally a mixture of money and stock (or stock options). Executives commonly receive bonuses based upon short-term corporate performance. Incentivizing officers and directors in this fashion often creates incentives toward short-term profits, rather than long-term performance. Further, in the current corporate structure, the selection of a CEO is often influenced by the controlling shareholder(s). In turn, the CEO often influences the selection of director candidates. This reality is much of what SOX and Dodd-Frank seeks to remedy.

    - *Example*: Dillon is CEO and director of a corporation. He is on the nomination committee, which proposes the names of directors for election to the board. Directors receive extensive benefits and membership on the board is highly desirable. He makes it known to all nominees that he supports that he expects to remain as CEO. When it is time to appoint a CEO and select a compensation package, the directors that Dillon nominated support Dillon and propose and very lucrative compensation package.

- *Improper Relationships* - Officers and directors owe fiduciary duties to the corporation. Particularly, officers and directors owe a duty of loyalty. That is, they cannot usurp corporate opportunities or seek personal gain at the expense of the corporation. Officers and directors are in control of extensive corporate assets and resources. This environment lends itself to the improper receipt of benefits by these individuals.

    - *Examples*: Common examples of improper relationships may include: close personal relationships between officers and directors, personal loans from the corporation to officers or directors, improper use of corporate assets, misallocation of corporate funds, corporate donations to political activities, etc.

- ***Discussion***: Do you believe that the alignment of benefits can create conflicts of interest in the corporation? Why or why not? How do you feel about individuals holding multiple stakeholder positions within the corporation? Does this implicate the duty of loyalty? Why or why not?

- ***Practice Question***: Tammy is a major shareholder, chairman (director), and CEO of ABC Corp. Can you provide examples of the types of incentives that may conflict in each of her roles?

- ***Resource Video***: http://thebusinessprofessor.com/alignment-of-benefits-and-corporate-governance-issues/